msft

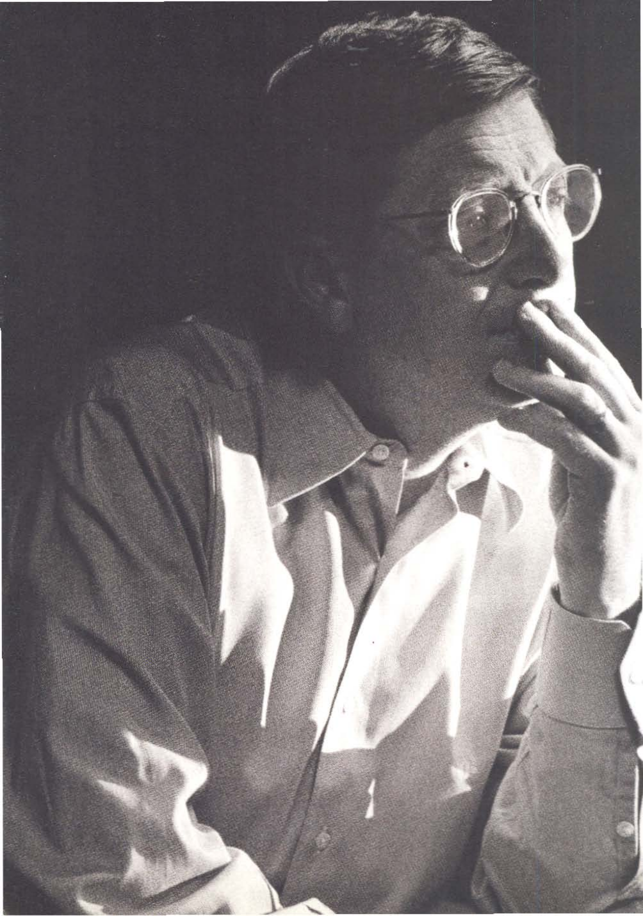
contents

financial highlights

(in millions, except earnings per share)

year ended june 30	1993	1994	1995	1996	1997
Revenue	$3,753	$4,649	$5,937	$ 8,671	$11,358
Net income	953	1,146	1,453	2,195	3,454
Earnings per share[1]	0.79	0.94	1.16	1.71	2.63
Return on revenue	25.4%	24.7%	24.5%	25.3%	30.4%
Cash and short-term investments	$2,290	$3,614	$4,750	$ 6,940	$ 8,966
Total assets	3,805	5,363	7,210	10,093	14,387
Stockholders' equity	3,242	4,450	5,333	6,908	10,777

[1] earnings per share have been restated to reflect a two-for-one stock split in December 1996



to our shareholders

1997 was an outstanding year. Our customers were asking for Microsoft to build products that allowed them to get business benefit out of the Internet, and we delivered. Across the board, with productivity applications, tools, desktop systems, and server products, we are gaining significant momentum. Like any time in our 23-year history we have great opportunities but face a number of threats.

Our top priority in fiscal 1998 is simplicity: reducing the total cost of ownership, and reducing complexity. We will need to keep this focus even as we roll out numerous products, and while competitors are battling with us on many fronts.

As we chart our path going forward, we are focused on four key areas:

Windows on the desktop. A few years ago, we developed the concept of "Windows Everywhere," an architecture that allows customers to have a family of operating systems and a set of compatible applications spanning a family of devices from the very small to the very large. We've had great success moving computing desktops to 32-bit systems – Microsoft® Windows® 95 and Windows NT® Workstation – as well as introducing Windows CE, a new version of the Windows operating system initially focused on handheld devices for mobile professionals. Microsoft Internet Explorer 4.0 will be another major step on our way to marrying the PC and the Internet. A core strength of Windows is its collection of development tools, allowing developers to tap into the richness of our platform and get great performance from their applications.

Productivity applications. Microsoft Office 97 was a major release, setting a new bar for features, functionality and integration. We put years of R&D into it and incorporated some of the discoveries coming out of our Research Division. Office 97 features natural language systems and sophisticated grammar checking. But that is just a start. Our goal is to allow people to get their work done in the easiest way possible, without thinking about the tools they're using.

Enterprise solutions. Windows NT Server and the Microsoft BackOffice® family line of server applications are growing at a phenomenal rate. As computer chips have become faster and faster, we have been able to deliver performance to customers previously accomplished only by mainframes. And beyond performance, we are now focused on simplicity and manageability. But there is still a lot more we intend to do to make high-end computing easier and less costly.

Interactive media and services. Our Interactive Media Group (IMG) has three areas of concentration: packaged software, hardware, and online services. All are about

enhancing the consumer experience around the PC and Web lifestyle. Our packaged software efforts are focused on delivering great titles in the games, learning, personal finance and mapping categories. For hardware, our goal is to enhance the software experience.

In online services, the focus is on producing an exciting combination of software and content that will help customers tap the power of the Internet to lead more informed, more fun and more productive lives. Increasingly, you'll see us emphasizing products and services where excellence in software makes the difference. Some of the investments we are making in this new area will pay off — others won't. We still have a lot of learning to do. Just like everyone else on the Web, we don't know what the mix of revenue will be — subscription, advertising, or promotions.

Digital Nervous System

I use the phrase "digital nervous system" to mean the electronic system that companies use to solve business and customer problems. A great digital nervous system starts with a powerful operating system and network, but if any business is to automate, it also has to have a great database system and messaging system. Microsoft has, over the years, invested heavily in the technical development of Microsoft SQL Server™ and Microsoft Exchange, as well as other components of Microsoft BackOffice, hiring the best people and building products with great performance and interoperability.

This year we are also going to invest heavily in the technical and marketing support of software developers and solution providers in vertical markets. We want to ensure that virtually any customer will be able to find their specific business application on a high-performance Windows-based system. You're also going to see broader coverage of corporate accounts worldwide. These are major investments in a time of moderate sales growth.

On May 20, we met with customers on Scalability Day, an important milestone because we demonstrated that any company, of any size, can run its business on our software, using solutions built on top of PC hardware. Hardware manufacturers have been busy producing world-class machines for a fraction of the price of mainframes. I am very optimistic that customers in the enterprise space will recognize, as they have on the desktop, that increasing performance, rising quality and falling prices make personal computer servers the best choice.

Simplicity

In fiscal 1998, we expect to spend nearly $2.6 billion on research and development, broadly defined. It's very exciting for me to see Microsoft bringing in world-class experts to work on areas like networking, security, graphics and linguistics.

Our industry makes incredible productivity devices that are impacting people around the world. But the complexity of technology has prevented users and system administrators from getting maximum value from their investments. Across the board, in applications, tools, desktop and server systems and interactive content, we have to make things simpler for users and system administrators. The three broad areas are Total Cost of Ownership (TCO) and manageability, reducing complexity, and new, simpler devices on the low-end.

Total Cost of Ownership. Addressing TCO is important for companies of all sizes. And the issue is not just reducing costs — it's about increasing usability and functionality without increasing complexity. Our Zero Administration Initiative is the focus here.

We believe every knowledge worker should have a personal computer. We believe employees are more than cogs in a machine. We believe businesses succeed because of the intelligence and creativity of their employees. We believe that in order for a business to stay competitive in this fast-paced world, it needs a digital approach. But to allow our customers to reap the true rewards of building a digital nervous system, we need to help them get off the treadmill of having to dedicate so many of their resources just to keep systems up and running.

Windows NT Server 5.0 is a major breakthrough in addressing TCO issues. It will allow an organization to easily control user configurations, to intelligently mirror the client machine's state on the server, and to allow users to roam from machine to machine. We also will enable mobile users to get the full benefit of their machines while traveling and have the ability to fully synchronize with the server when they return, so their local data and system state are protected. We will combine the power and flexibility of the PC with the benefits of central management.

Reducing complexity. Though we firmly believe in the power of the personal computer, it's not always true that one size fits all. Some customers have older PC hardware that for various reasons they are not ready to upgrade. Some need a simpler, standard configuration for many workers. Some customers have existing investments in terminals.

We have worked with other companies to introduce the NetPC and Windows-based terminals. The NetPC is a simpler, easily managed PC configuration for corporate desktops that PC manufacturers are beginning to roll out now. The technology behind Windows-based terminals helps customers by extending the life of older, less-powerful PCs by running a limited number of newer applications off a server, and opens a new customer segment to us.

New devices. "Windows Everywhere" means we're scaling down as well as up. Our Windows CE operating system is initially focused on handheld devices. Users will range from retail clerks monitoring inventory to healthcare workers charting patients to utility workers installing electrical lines.

Windows CE will also be suitable for still smaller "wallet" PCs, wireless-communication devices such as digital information pagers and cellular smart phones, next-generation entertainment and multimedia consoles, including game machines and smarter DVD players and purpose-built Internet access devices such as WebTVs, digital set-top boxes for cable and satellite systems and Internet "Web phones."

Connected PCs, Connected TVs

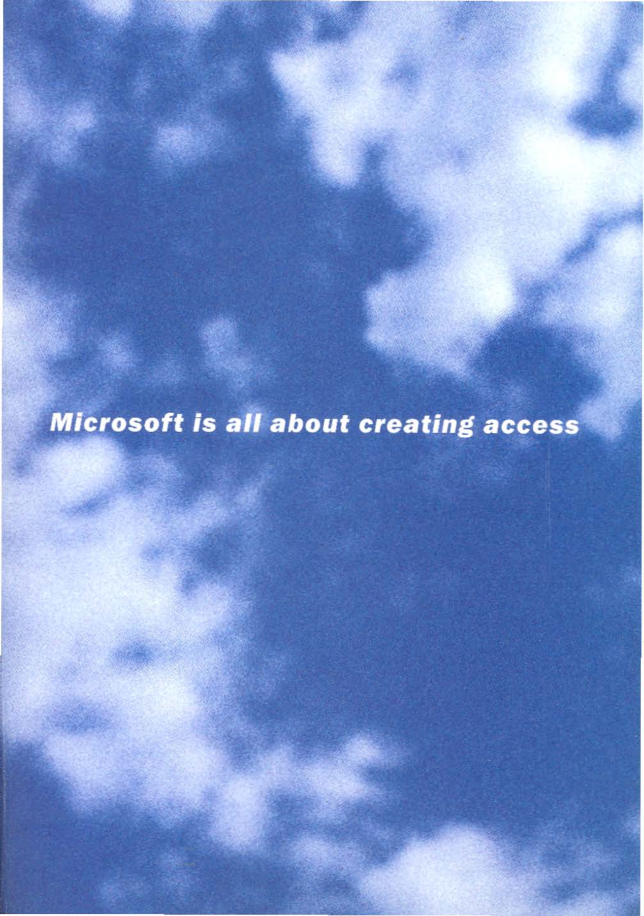
We've long held the belief that the PC was moving from the stand-alone PC to the connected PC. Today, this is well under way. PC networks are broadly prevalent in business, and the Internet is creating a worldwide web of PCs. Windows NT 5.0 and Windows 98 will do more to make PCs connected. Our vision has now evolved to the "Connected PC and the Connected TV" – the idea of integrating the intelligence and interactivity of PCs with the video and sound of TV. This will accelerate as TV moves to a digital format. Making this vision a reality is reliant on the physical infrastructure – the high-speed connections – that will join these devices. Earlier this year, we invested in Comcast, the U.S.'s fourth-largest cable company, primarily to spur the cable and phone industries to build two-way, high-speed networks. We acquired WebTV to hasten the day when TVs and PCs use Windows technologies, providing complementary sources of information and entertainment in the home. Windows CE, a compatible subset of our Windows family, makes it a lot easier for consumer electronics manufacturers to do things such as a customized guide to television shows or applications to let you view Web pages and see simple electronic mail on your TV, control home heating and lighting systems or even let you connect up a digital camera and post or e-mail photos using the Internet.

These developments, and our work in IMG, will help make the "Web lifestyle" a reality. This is a lifestyle in which people take advantage of the Internet to lead more informed and productive lives, and have more fun. With a Web lifestyle, people will naturally turn to the Internet first to get information, manage their finances, make better purchase and travel decisions and communicate with friends and others with whom they have common interests.

Our business is one of risks and challenges and great potential rewards. I appreciate the continuing trust and support of our shareholders in the long-term vision and potential of this company. I am confident that through the dedication and hard work of our employees, we can deliver the products and services that will mean success for both Microsoft and our customers.

William H. Gates

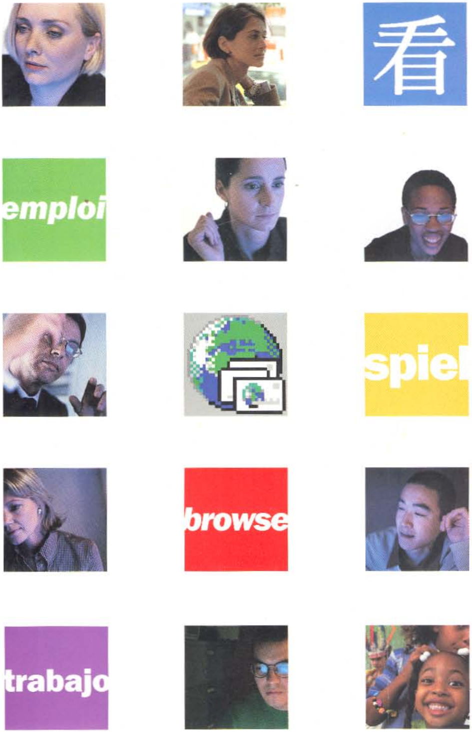
William H. Gates

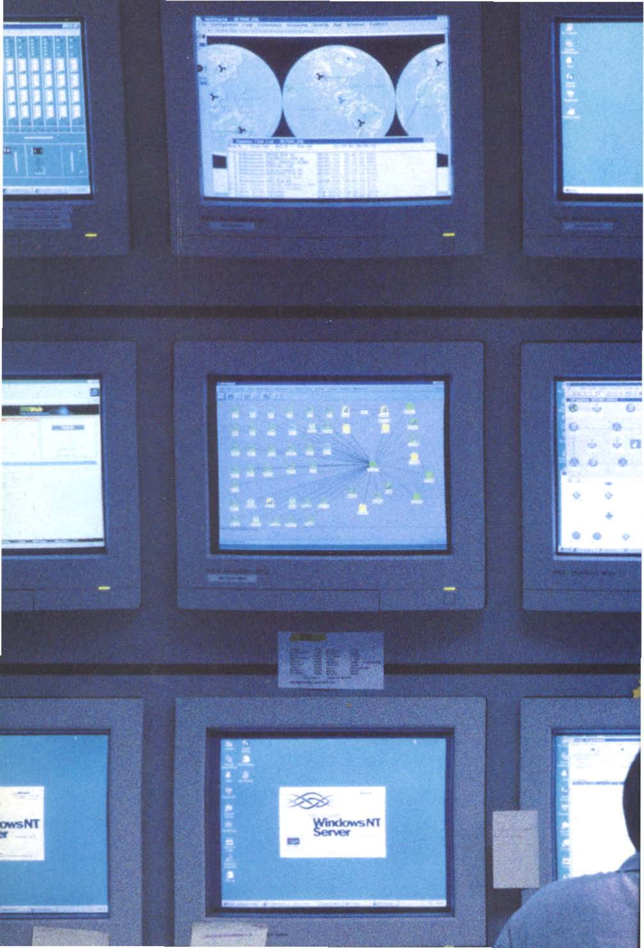

Microsoft is all about creating access

Generating ideas and making discoveries is so integral to what we do that exciting <u>new possibilities emerge every day</u>. Possibilities for offering the flexibility that makes work rewarding for the individual while at the same time helping businesses increase the manageability of their information and their systems. Possibilities for making the way people interact with systems, and systems with people, more natural. Possibilities for continually lowering the cost of PC ownership while increasing the value. Possibilities for enhancing functionality and features while making everything instantaneous, transparent and simple. Possibilities for making everything integrated, compatible and intuitive. All our opportunities come from continuing to discover new possibilities. Our success is based on listening to our customers and turning these possibilities into valuable, marketable products capable of making the impossible, completely possible.

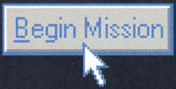
so, everything you're doing *works*

For things to work together, there needs to be equal respect for the demands of organizations and the needs of individuals, between a way of doing things, and a way to make what you're doing your own. With what we learn from our customers and what we discover in our work, the goals driving Microsoft technology today are to achieve true integration and **reduce complexity**. To make information, and the ideas that information represents, even more transportable, compatible, flexible, malleable. Windows lets you reach these goals by doing exactly what the name implies: making technology transparent. So that when you work, you experience your work, not your operating system and not your application. From the power of Windows NT to the performance and accessibility of Windows 95 to the portability of Windows CE, complexity is being transformed into ease, giving you what you want, when and how you want it, wherever you want it. And that's possible only because Windows is conceived and built as a standard for computing.


看
emploi
spiel
browse
trabajo


Windows NT
Server

on your intranet and the *Internet*



Tie your corporate intranet to the worldwide Internet and you can have the world online and on your desktop. Where you share analysis, news, projections, reports. Where you develop concepts and presentations, send messages and plans. Where you evaluate performance, workflow, schedules, specifications. Where ideas and data merge. Over the last year, Microsoft Internet Explorer 3.0 captured the attention of people worldwide. Corporate accounts, more than eight million desktops, have made Internet Explorer their browser of choice. The new Internet Explorer 4.0 unites Windows and the Internet with the Active Desktop™ interface. That union makes creating, selecting and directing information and ideas fluid and immediate. Active Channel™ technologies deliver your favorite content from anywhere in the world right to your desktop, in a way that's customized for you. Connected from the laptop to the desktop to the Internet, time and distance don't matter anymore. All that matters is what you need. It helps you win. Which is what our customers asked us to do: deliver on the promise of automation by replacing barriers with a data stream that can take you anywhere and everywhere.

scaling up to 1 billion transactions a day

It's a measure of how far the PC, and PC networks, have come. And how much farther they can go in bringing greater flexibility, higher productivity and lower cost to a computing environment that has traditionally operated with expensive, proprietary systems that demand almost constant maintenance. Consider managing an entire enterprise database, one hundred million Web site hits, 1.8 million e-mails or one billion ATM transactions a day with a PC network. That is precisely the power you have with our BackOffice platform. Windows NT Server, SQL Server, Exchange Server and other BackOffice servers are already at work for private and public companies and government agencies. The promise of this technology is in opening an enormous market to our products, extending our reach from the Internet to the desktop and throughout the enterprise. It's a new paradigm, and we think people will see the immediate value of the choice we offer between perpetuating proprietary systems or embracing **efficient, open, scalable systems**. We believe the latter to be the right choice. Our approach to enterprise computing achieves quantifiable increases in efficiency and productivity, with dramatic cost savings. It's a combination everyone wants.

starting up an Office all your own

Our systems and applications have become engines for growth. Not just for the growth of Microsoft, but for the growth of our customers. With two decades of continuous effort and market feedback, we offer products powerful enough to take into account how people want to work, which is crucial in helping companies take the next step in productivity. By integrating our systems and making it easier for businesses to use PCs, we are creating genuine value. For large organizations and small, our products offer a whole new level of performance. More than 65 million people worldwide have made Microsoft Office and its individual business applications far and away the most popular in use today. Performance isn't the beginning and end. **Manageability and effectiveness** must follow, directed to one goal: simplicity. Business is complex enough. With the release of Microsoft Office 97, the rules change. Office 97 integrates communication and collaboration, making document creation an interactive process. Making it easier to manage the increasingly complex flow of electronic information to the desktop. We realize better than most that using technology must be an asset, not a hindrance. Our software has the power to really make it easy, so people can focus on their work, not on the tools they're using.

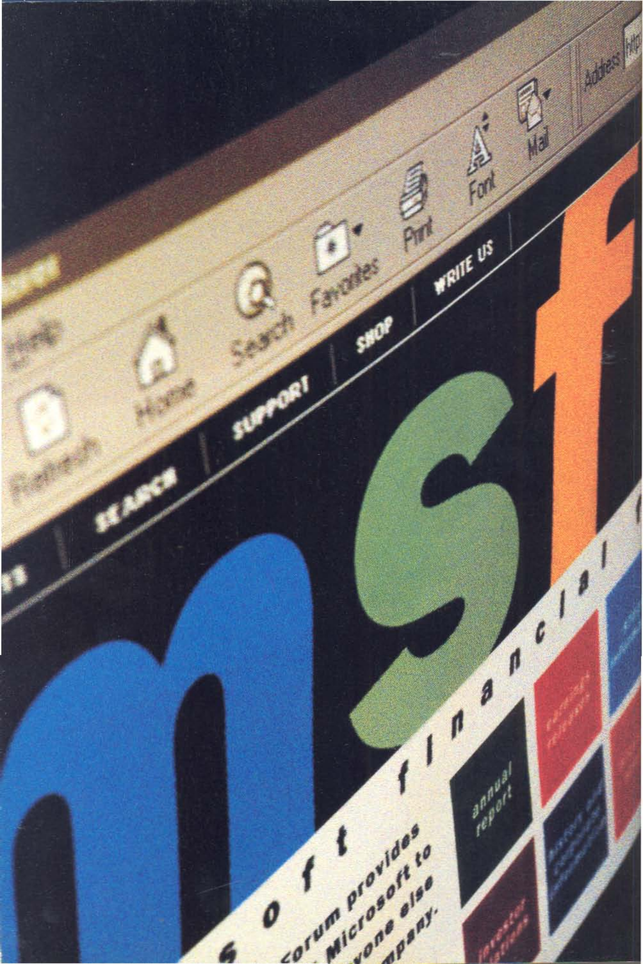
going farther than you thought you could

Where do you want to go today?® isn't a figurative question. The Expedia™ travel service and its licensed offspring at American Express, Northwest Airlines and Continental Airlines are already booking an average of 10,000 seats a week for business and personal travel, making Expedia one of the top electronic commerce applications on the Internet. It's flexible enough to be configured to the individual travel policies of any company. It saves time, money and headaches. The Sidewalk™ city guide is helping people find the dining, arts, entertainment and recreation experiences they want in New York, Seattle, Boston, the Twin Cities and more cities soon. MSNBC transforms the familiar into something really new. By combining the world-class technology of Microsoft with the world-leading news resources of NBC, MSNBC is attracting more than two million users each month. All of this and more is available over MSN™, The Microsoft Network, right now. In an era of rapid change, online services and entertainment have the potential to set the pace. We'll keep learning about what the technology offers, what people want in both form and content and using what we know. And we already know that the only thing that will truly bring the power of the Internet to consumers is the combination of unique content and a fast, easy-to-use delivery system, like TV sets. With our investments in WebTV and Comcast we are acting on a commitment to radically improve the delivery of Internet-based content. It's not about trying to change the nature of our business, it's about extending its reach.

Expedia
newyork.sidewalk
THE THURSDAY REVIEW
ZONE
Play games on-line
all over the world.
inicio
webtv
WHAT'S ON IT
webzine
MSNBC
investor
Slate
MICROSOFT
PRODUCTS
MSN CD-ROM
無償配布中

and coming back to what you *really* love

We want technology to help **make life better**. Not just at the office, but at home and all points in between. Better by making learning fun. Better by letting you play as hard as you work. Better by managing your budget, tracking your investments and planning your vacation. The top-selling Encarta® multimedia encyclopedia now features more than 10,000 links to related Web sites, creating an unmatched depth of information and access that was simply impossible only a few years ago. More than 100,000 people visit Microsoft Investor every day. The *Slate*™ online magazine has become one of the most respected Webzines published. The Internet Gaming Zone links over 500,000 players from all over the world to interactive competition and a game library of today's hottest titles. We are linking television programs to interactive toys, bringing form and function closer together, so that these products and services have more meaning, more importance and offer more value to the lives of people everywhere. The promise of these technologies and markets is immense. And, ultimately, our efforts in interactivity are another aspect of everything we do with software: creating even more possibilities.


Address
Mail
Font
Print
Favorites
Search
Home
WRITE US
SHOP
SUPPORT
SEARCH
msft
financial
annual report
Forum provides
Microsoft to

get online
with the
financials
@ http://www.
microsoft.
com/msft/

income statements

(in millions, except earnings per share)

year ended june 30	1995	1996	1997
Revenue	$5,937	$8,671	$11,358
Operating expenses:			
Cost of revenue	877	1,188	1,085
Research and development	860	1,432	1,925
Sales and marketing	1,895	2,657	2,856
General and administrative	267	316	362
Total operating expenses	3,899	5,593	6,228
Operating income	2,038	3,078	5,130
Interest income	191	320	443
Other expenses	(62)	(19)	(259)
Income before income taxes	2,167	3,379	5,314
Provision for income taxes	714	1,184	1,860
Net income	1,453	2,195	3,454
Preferred stock dividends	–	–	15
Net income available for common shareholders	$1,453	$2,195	$ 3,439
Earnings per share[1]	$ 1.16	$ 1.71	$ 2.63
Weighted average shares outstanding[1]	1,254	1,281	1,312

see accompanying notes

[1] share and per share amounts have been restated to reflect a two-for-one stock split in December 1996

cash flows statements

year ended june 30	1995	1996	1997
		(in millions)	
Cash flows from operations			
Net income	$ 1,453	$ 2,195	$ 3,454
Depreciation and amortization	269	480	557
Unearned revenue	69	983	1,601
Recognition of unearned revenue from prior periods	(54)	(477)	(743)
Other current liabilities	404	584	321
Accounts receivable	(91)	(71)	(336)
Other current assets	(60)	25	(165)
Net cash from operations	1,990	3,719	4,689
Cash flows used for financing			
Common stock issued	332	504	744
Common stock repurchased	(698)	(1,385)	(3,101)
Put warrant proceeds	49	124	95
Preferred stock issued	–	–	980
Preferred stock dividends	–	–	(15)
Stock option income tax benefits	179	352	796
Net cash used for financing	(138)	(405)	(501)
Cash flows used for investments			
Additions to property, plant, and equipment	(495)	(494)	(499)
Equity investments and other	(230)	(625)	(1,669)
Short-term investments	(651)	(1,551)	(921)
Net cash used for investments	(1,376)	(2,670)	(3,089)
Net change in cash and equivalents	476	644	1,099
Effect of exchange rates on cash and equivalents	9	(5)	6
Cash and equivalents, beginning of year	1,477	1,962	2,601
Cash and equivalents, end of year	1,962	2,601	3,706
Short-term investments	2,788	4,339	5,260
Cash and short-term investments	$ 4,750	$ 6,940	$ 8,966

see accompanying notes

Cash flows from operations	$1,990	$3,719	$4,689

management's discussion and analysis

Results of Operations for 1995, 1996, and 1997

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including scalable operating systems for information appliances, personal computers (PCs), and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company has recently expanded its interactive content efforts, including entertainment and information software programs, MSN, The Microsoft Network online service, Internet-based services, and alliances with companies involved with other forms of digital interactivity. Microsoft also sells personal computer input devices and books, and researches and develops advanced technologies for future software products.

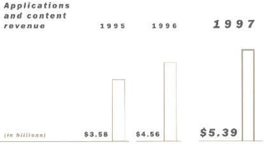
Revenue

The Company's revenue grew 46% in the fiscal year ended June 30, 1996 and 31% in fiscal 1997. Revenue growth was particularly strong in 1996 due to the retail introduction of the Microsoft Windows 95 operating system. Software license volume increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate and organization license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. During 1996 and 1997, an increased percentage of products and programs became subject to ratable revenue recognition, such as Windows operating systems, Office 97, maintenance, and other subscription models. (See accompanying notes.)

Product groups Microsoft has a Platforms Product Group and an Applications and Content Product Group.

Platforms Product Group revenue was $2.36 billion, $4.11 billion, and $5.97 billion in 1995, 1996, and 1997. Platform revenue is primarily from licenses of PC operating systems, business systems with client/server architectures, and software development tools.

The Company's principal desktop platform products in 1996 and 1997 were its 32-bit operating systems, Microsoft Windows 95 and Microsoft Windows NT Workstation. Released in August 1995, Windows 95 was a successor to MS-DOS® and Microsoft Windows 3.x operating systems. Windows NT Workstation version 4.0 was released in fiscal 1997. Desktop operating systems increasingly contributed to revenue as shipments of new PCs preinstalled with such systems increased rapidly during the three-year period. Additionally, increased penetration of higher value 32-bit operating systems led to growth in 1996 and 1997. In 1996, retail license sales of Windows 95 were a major factor in the Platforms revenue increase, reflecting the typical sales pattern for major operating system upgrades. Also in 1996, a portion of Windows operating system revenue became subject to ratable recognition.



management's discussion continued

Business systems products offer an enterprise-wide distributed client/server environment based on the Microsoft Windows NT Server operating system and the server applications in the Microsoft BackOffice family of products. Revenue from these products increased strongly in 1995, 1996, and 1997 due to greater corporate demand, particularly for intranet solutions.

Revenue from developer products increased steadily in all three years, as more independent software vendors, corporate developers, and solutions developers licensed tools such as the Microsoft Visual Basic® programming system to develop software for Windows 95 and Windows NT operating systems and the Internet.

Applications and Content Product Group revenue was $3.58 billion, $4.56 billion, and $5.39 billion in 1995, 1996, and 1997. Applications and Content revenue includes primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. Microsoft Office for Windows 95 was released in fiscal 1996 and Microsoft Office 97 was released in fiscal 1997. Applications and Content revenue grew 27% in 1996 and 18% in 1997. The lower growth rate in 1997 was due to the expected impact of saturation of desktop applications, the continued shift in mix toward corporate licenses from packaged products, and the ratable revenue recognition model for Office 97.

Absolute increases in desktop applications revenue during the three-year period were led by Microsoft Office. The primary programs in Microsoft Office are Microsoft Word word processor, Microsoft Excel spreadsheet, and Microsoft PowerPoint® presentation graphics program. Various versions of Office, which are available for the 32-bit version of Windows, the 16-bit version of Windows, and Macintosh® operating systems, also include Microsoft Access database management program, Microsoft Outlook™ desktop information manager, or other programs. Revenue from stand-alone versions of Microsoft Excel, Microsoft Word, and Microsoft PowerPoint continued to decrease as the sales mix shifted to integrated product suites. Microsoft Project scheduling and project management program revenue increased during the three-year period.

Microsoft offers a broad range of interactive media products, which also showed moderate growth. Products include CD-ROM multimedia reference titles and programs for home and small office productivity, children's creativity, and entertainment. In addition to The Microsoft Network, recently introduced online Internet services include travel information and reservations, local event information, and new-car buying.

The Company also markets input devices. Mouse and gaming device sales increased while keyboard revenue was steady during the three-year period.

Sales channels The Company distributes its products primarily through OEM licenses, corporate and organizational licenses, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: the United States and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate and organization licenses and packaged products in these channels are primarily to distributors and resellers.

OEM channel revenue was $1.65 billion in 1995, $2.50 billion in 1996, and $3.48 billion in 1997. The primary source of OEM revenue is the licensing of desktop operating systems, and OEM revenue is highly dependent on PC shipment volume.

management's discussion continued

Licensing programs continued to grow in popularity across all geographic areas during the three-year period. Packaged product volume increased in 1996 due to the release of retail upgrade versions of Windows 95. U.S. and Canadian channel revenue was $1.88 billion, $2.68 billion, and $3.41 billion in 1995, 1996, and 1997. Revenue in Europe was $1.49 billion, $2.02 billion, and $2.54 billion in 1995, 1996, and 1997. Growth rates have been lower in Europe than in other geographic areas due to general economic slowness, higher existing market shares, and a more dramatic shift to licensing programs. Other International channel revenue was $924 million in 1995, $1.47 billion in 1996, and $1.93 billion in 1997. Growth rates were higher in the Other International channel due to customers accepting newly localized products, particularly in Japan, and penetration in emerging markets.

The Company's operating results are affected by foreign exchange rates. Approximately 37%, 34%, and 32% of the Company's revenue was collected in foreign currencies during 1995, 1996, and 1997. Since a portion of local currency revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

Operating expenses

Cost of revenue As a percentage of revenue, cost of revenue was 14.8% in 1995, 13.7% in 1996, and 9.6% in 1997. The decrease was due to the shifts in mix to CD-ROMs (which carry lower cost of goods than disks), licenses to OEMs and corporations, and higher-margin Windows NT Server and other BackOffice server products.

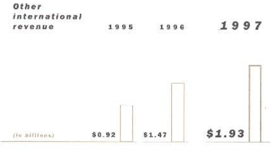
Research and development Microsoft invested heavily in the future by funding research and development (R&D). Expense increases of 67% in 1996 and 34% in 1997 resulted primarily from development staff headcount growth and higher levels of third-party development costs in many areas, including continued development efforts for Windows desktop operating systems, Office, BackOffice, and Internet and intranet technologies. R&D costs also increased for development tools, consumer systems, and interactive media initiatives such as MSN and other online services.

Sales and marketing The increase in the absolute dollar amount of sales and marketing expenses in the three-year period was due primarily to expanded product-specific marketing programs, particularly for Windows 95 during 1996. Sales and marketing costs as a percentage of revenue decreased, particularly in 1997, reflecting moderate headcount growth. Also in 1997, Microsoft brand advertising and product support expenses declined.

General and administrative Increases in general and administrative expenses were primarily attributable to growth in the number of people and computer systems necessary to support overall increases in the scope of the Company's operations.

Nonoperating items and income taxes

Interest income increased primarily as a result of a larger investment portfolio generated by cash from operations. Other expenses increased due to recognition of Microsoft's share of joint venture activities, including DreamWorks Interactive and the MSNBC entities. During 1995, Microsoft paid a $46 million



management's discussion continued

breakup fee to Intuit Inc. in connection with the termination of a planned merger. The effective income tax rate was 33% in 1995 and 35% in 1996 and 1997.

Net income

Net income as a percent of revenue increased in 1996 and 1997 due to the lower relative cost of revenue, sales and marketing expenses, and general and administrative expenses, partially offset by investments in research and development and joint ventures.

Financial Condition

Microsoft's cash and short-term investment portfolio totaled $8.97 billion at June 30, 1997. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

During 1996, Microsoft and National Broadcasting Company (NBC) established two joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

During 1997, Microsoft invested $1.0 billion in Comcast Corporation, a cable television and diversified telecommunications company. Comcast Special Class A common stock of $500 million and convertible preferred stock of $500 million are included in equity investments on the balance sheet.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at June 30, 1997 was $10.78 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology and to fund ventures and other strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for research and development, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $300 million on June 30, 1997.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. Despite recent increases in stock repurchases, the buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 154 million common shares for $6.2 billion while 363 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $30.2 billion as of June 30, 1997. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of $980 million were used to repurchase common shares.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next 12 months. Microsoft's cash and short-term investments are available for strategic investments, mergers and acquisitions, other potential large-scale cash needs that may arise, and to fund an increased stock buyback program over historical levels to reduce the dilutive impact of the Company's employee stock option and purchase programs.

Microsoft has not paid cash dividends on its common stock. The preferred stock pays $2.196 per annum per share.

management's discussion continued

Outlook: Issues and Uncertainties

Microsoft does not provide forecasts of future financial performance. While Microsoft management is optimistic about the Company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its growth outlook.

Rapid technological change and competition Rapid change, uncertainty due to new and emerging technologies, and fierce competition characterize the PC software industry. The pace of change has recently accelerated due to the Internet and new programming languages, such as Java™.

Future initiatives The Company is expanding its efforts to provide and support mission-critical systems to large enterprises. Scalability of BackOffice server and application products, manageability of Windows- and Office-based systems, and Internet and intranet integration are also major focus areas. Additionally, Microsoft is committed to providing technologies, operating systems, and interactive content for the future convergence of PCs, televisions, and the Internet. Future revenue from these initiatives may not duplicate historical revenue growth rates.

PC growth rates The underlying PC unit growth rate, which may decrease in the future, directly impacts software revenue growth.

Product ship schedules Shipments of new versions of major products such as Windows 95 have generally had positive impacts on revenue growth rates. The Company does not currently expect that individual products to be released in 1998 will repeat the financial performance of Windows 95. Also, delays in new-product releases can cause operational inefficiencies that impact manufacturing and distribution logistics, independent software vendor (ISV) and OEM relationships, and telephone support staffing.

Customer acceptance While the Company performs extensive usability and beta testing of new products, user acceptance and corporate penetration rates ultimately dictate the success of development and marketing efforts.

Prices Future product prices may decrease from historical levels, depending on competitive market and cost factors. European and Far Eastern software prices vary by country and are generally higher than in the United States to cover localization costs and higher costs of distribution. Increased global license agreements, European monetary unification, or other factors could erode such price uplifts in the future.

Earnings process An increasingly higher percentage of the Company's revenue is subject to ratable recognition. Subsequent product support and delivery of unspecified enhancements require the applicable portion of revenue for certain products to be recognized over the product's life cycle. This policy may be required for future products, depending on specific license terms and conditions. Also, maintenance and other subscription programs may continue to increase in popularity, particularly with corporations and other large organizations.

Saturation Product upgrades, which enable users to upgrade from earlier versions of the Company's products or from competitors' products, have lower prices and margins than new products. As the desktop applications market has become saturated, the sales mix has shifted from standard products to upgrade products. This trend is likely to continue.

Corporate licenses Average revenue per unit from corporate and organization license programs is lower than average revenue per unit from retail versions shipped through the finished goods channels. Unit sales under licensing programs may continue to increase.

Channel mix Average revenue per license is lower from OEM licenses than from retail versions, reflecting the relatively lower direct costs of operations in the OEM channel. An increasingly higher percentage of revenue was achieved through the OEM channel during 1996 and 1997.

management's discussion continued

Integrated suites The price of integrated suites, such as Microsoft Office, is less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. Revenue from integrated suites may continue to increase as a percentage of total revenue.

Cost of revenue Although cost of revenue as a percentage of revenue decreased in 1996 and 1997, it varies with channel mix and product mix within channels. The trend of declining cost of revenue as a percentage of revenue is unlikely to continue in 1998.

Pay and participation model Microsoft employees currently receive salaries, incentive bonuses, other fringe benefits, and stock options. New government regulations, poor stock price performance, or other factors could diminish the value of the option program and force the Company into more of a cash compensation model. Had the Company paid employees in cash the grant date Black-Scholes value of options vested in 1995, 1996, and 1997, the pretax expense would have been approximately $310 million, $450 million, and $620 million.

Long-term research and development investment cycle Developing and localizing software is expensive and the investment in product development often involves a long payback cycle. The Company plans to continue significant investments in software research and development and related product opportunities from which significant revenue is not anticipated for a number of years. Management expects total spending for research and development in 1998 to increase over spending in 1997.

Sales and marketing and support investments The Company's plans for 1998 include accelerated investments in its sales and marketing and support groups.

Foreign exchange A large percentage of the Company's sales, costs of manufacturing, and marketing is transacted in local currencies. As a result, the Company's international results of operations are subject to foreign exchange rate fluctuations.

Interest rate sensitivity The Company's cash and short-term investment portfolio is subject to interest rate risk. An abrupt increase in interest rates would decrease the market value of the Company's fixed income securities. For example, a 200 basis point increase in short-term treasury security yields would reduce the carrying value of the portfolio at June 30, 1997 by $200 million.

Intellectual property rights Microsoft diligently defends its intellectual property rights, but unlicensed copying of software represents a loss of revenue to the Company. While this adversely affects U.S. revenue, revenue loss is even more significant outside of the United States, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, Microsoft actively educates consumers on the benefits of licensing genuine products and educates lawmakers on the advantages of a business climate where intellectual property rights are protected. However, continued efforts may not affect revenue positively.

Future growth rate The revenue growth rate in 1998 may not approach the level attained in 1997, particularly when compared to the second half of 1997. As discussed above, operating expenses are expected to increase in 1998. Because of the fixed nature of a significant portion of such expenses, coupled with the possibility of slower revenue growth, operating margins in 1998 may decrease from those in 1997.

Litigation Litigation regarding intellectual property rights, patents, and copyrights occurs in the PC software industry. In addition, there are government regulation and investigation risks along with other general corporate legal risks.

balance sheets

(in millions)

june 30	1996	1997
Assets		
Current assets:		
Cash and short-term investments	$ 6,940	$ 8,966
Accounts receivable	639	980
Other	260	427
Total current assets	7,839	10,373
Property, plant, and equipment	1,326	1,465
Equity investments	675	2,346
Other assets	253	203
Total assets	$10,093	$14,387
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 808	$ 721
Accrued compensation	202	336
Income taxes payable	484	466
Unearned revenue	560	1,418
Other	371	669
Total current liabilities	2,425	3,610
Minority interest	125	–
Put warrants	635	–
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock – shares authorized 0 and 100; shares issued and outstanding 0 and 13	–	980
Common stock and paid-in capital – shares authorized 4,000; shares issued and outstanding 1,194 and 1,204	2,924	4,509
Retained earnings	3,984	5,288
Total stockholders' equity	6,908	10,777
Total liabilities and stockholders' equity	$10,093	$14,387

see accompanying notes

stockholders' equity statements

(in millions)

year ended june 30	1995	1996	1997
Convertible preferred stock			
Convertible preferred stock issued	—	—	$ 980
Balance, end of year	—	—	980
Common stock and paid-in capital			
Balance, beginning of year	$1,500	$ 2,005	2,924
Common stock issued	332	504	744
Common stock repurchased	(30)	(41)	(91)
Proceeds from sale of put warrants	49	124	95
Reclassification of put warrant obligation	(25)	(20)	45
Stock option income tax benefits	179	352	792
Balance, end of year	2,005	2,924	4,509
Retained earnings			
Balance, beginning of year	2,950	3,328	3,984
Net income	1,453	2,195	3,454
Preferred stock dividends	—	—	(15)
Common stock repurchased	(668)	(1,344)	(3,010)
Reclassification of put warrant obligation	(380)	(210)	590
Net unrealized investment gains and other	(27)	15	285
Balance, end of year	3,328	3,984	5,288
Total stockholders' equity	$5,333	$ 6,908	$10,777

see accompanying notes

Stockholders' equity

notes to financial statements

Significant accounting policies

Accounting principles The financial statements are prepared on a basis consistent with U.S. generally accepted accounting principles and International Accounting Standards formulated by the International Accounting Standards Committee (IASC).

Principles of consolidation The financial statements include the accounts of Microsoft and its subsidiaries. Significant intercompany transactions and balances have been eliminated. Investments in 50% owned joint ventures are accounted for using the equity method; the Company's share of joint ventures' activities is reflected in other expenses.

Estimates and assumptions Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates.

Foreign currencies Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to equity. Revenue, costs, and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in other expenses.

Revenue recognition Revenue is recognized when earned. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while revenue from corporate and organization license programs is recorded when the user installs the product. Revenue from packaged product sales to distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. Revenue attributable to significant support (technical support and unspecified enhancements such as service packs and Internet browser updates) is based on the price charged or derived value of the undelivered elements and is recognized ratably on a straight-line basis over the product's life cycle. Costs related to insignificant obligations, which include telephone support for certain products, are accrued. Provisions are recorded for returns and bad debts.

Research and development Research and development costs are expensed as incurred. The current U.S. accounting rule, Statement of Financial Accounting Standards (SFAS) 86, ***Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed***, does not materially affect the Company.

Telephone support Telephone support costs are included in sales and marketing.

Income taxes Income tax expense includes U.S. and international income taxes, plus an accrual for U.S. taxes on undistributed earnings of international subsidiaries. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

Earnings per share Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options using the "treasury stock" method and preferred shares using the "if-converted" method. Beginning in the second quarter of 1998, Microsoft will be required to report earnings per outstanding common share in addition to diluted earnings per share. Earnings per common share computed under the new pronouncement would have been $1.25, $1.85, and $2.87 while reported diluted earnings per share were $1.16, $1.71, and $2.63 in 1995, 1996, and 1997.

Stock split In December 1996, outstanding shares of common stock were split two-for-one. All share and per share amounts have been restated.

Financial instruments The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and five years from the purchase date. All cash and short-term investments are classified as available for sale and are recorded at market. Cost approximates market for all classifications of cash and short-term investments; realized and unrealized gains and losses were not material.

notes continued

Publicly tradeable equity securities are recorded at market; unrealized gains and losses are reflected in stockholders' equity.

Property, plant, and equipment Property, plant, and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 30 years.

Reclassifications Certain reclassifications have been made for consistent presentation.

Unearned revenue

In fiscal 1996, Microsoft committed to integrating its Internet technologies, such as the Company's Internet browser, Microsoft Internet Explorer, into existing products at no additional cost to its customers. Given this strategy and other support commitments such as telephone support, Internet-based technical support, and unspecified product enhancements, Microsoft recognizes approximately 20% of Windows operating systems revenue over the product life cycles, currently estimated at two years. The unearned portion of revenue from Windows operating systems was $425 million and $860 million at June 30, 1996 and 1997.

Since Office 97 is also tightly integrated with the rapidly evolving Internet, and subsequent delivery of new Internet technologies, enhancements, and other support is likely to be more than minimal, a ratable revenue recognition policy became effective for Office 97 licenses beginning in 1997. Approximately 20% of Office 97 revenue is recognized ratably over the estimated 18-month product life cycle. Unearned revenue associated with Office 97 totaled $300 million at June 30, 1997.

Unearned revenue also includes maintenance and other subscription contracts, including custom corporate license agreements.

Financial risks

The Company's investment portfolio is diversified and consists primarily of short-term investment grade securities. At June 30, 1996 and 1997, approximately 38% and 31% of accounts receivable represented amounts due from 10 channel purchasers. One customer accounted for approximately 12%, 13%, and 12% of revenue while another customer accounted for approximately 12%, 8%, and 5% of revenue in 1995, 1996, and 1997.

Finished goods sales to international customers in Europe, Japan, and Australia are primarily billed in local currencies. Payment cycles are relatively short, generally less than 90 days. European manufacturing costs and international selling, distribution, and support costs are generally disbursed in local currencies. Local currency cash balances in excess of short-term operating needs are generally converted into U.S. dollar cash and short-term investments on receipt. Therefore, foreign exchange rate fluctuations generally do not create a risk of material balance sheet gains or losses. As a result, Microsoft's hedging activities for balance sheet exposures have been minimal.

At June 30, 1997, the Company had contracts to deliver $500 million in a foreign currency, expiring July 1998, which hedge foreign exchange rate risk related to a foreign currency denominated investment.

Foreign exchange rates affect the translated results of operations of the Company's foreign subsidiaries. The Company hedges a percentage of planned international revenue with purchased options. The notional amount of the options outstanding at June 30, 1997 was $2.1 billion. At June 30, 1997, the fair value and premiums paid for the options were not material.

notes continued

(in millions)

Cash and short-term investments

june 30	1996	1997
Cash and equivalents:		
Cash	$ 64	$ 246
Commercial paper	1,664	1,660
Money market preferreds	105	946
Certificates of deposit	768	854
Cash and equivalents	2,601	3,706
Short-term investments:		
Municipal securities	1,357	571
Corporate notes and bonds	1,125	1,907
U.S. Treasury securities	1,591	1,513
Certificates of deposit	266	1,269
Short-term investments	4,339	5,260
Cash and short-term investments	$6,940	$8,966

Property, plant, and equipment

june 30	1996	1997
Land	$ 183	$ 183
Buildings	787	1,027
Computer equipment	885	1,064
Other	491	503
Property, plant, and equipment – at cost	2,346	2,777
Accumulated depreciation	(1,020)	(1,312)
Property, plant, and equipment – net	$ 1,326	$ 1,465

During 1996 and 1997, depreciation expense, of which the majority related to computer equipment, was $363 million and $353 million; disposals were immaterial.

notes continued

(in millions)

Income taxes

The provision for income taxes consisted of:

year ended june 30	1995	1996	1997
Current taxes:			
U.S. and state	$518	$1,139	$1,710
International	151	285	412
Current taxes	669	1,424	2,122
Deferred taxes	45	(240)	(262)
Provision for income taxes	$714	$1,184	$1,860

U.S. and international components of income before income taxes were:

year ended june 30	1995	1996	1997
U.S.	$1,549	$2,356	$3,775
International	618	1,023	1,539
Income before income taxes	$2,167	$3,379	$5,314

Income taxes payable were:

june 30	1996	1997
Deferred income tax assets:		
Revenue items	$ 193	$ 474
Expense items	322	505
Deferred income tax assets	515	979
Deferred income tax liabilities:		
International earnings	(261)	(465)
Other	(6)	(4)
Deferred income tax liabilities	(267)	(469)
Current income tax liabilities	(732)	(976)
Income taxes payable	$(484)	$(466)

Income taxes have been settled with the Internal Revenue Service for all years through 1989. The IRS has assessed taxes for 1990 and 1991 that the Company is contesting in Tax Court. The IRS is examining the Company's U.S. income tax returns for 1992 through 1994. Management believes any related adjustments that might be required will not be material to the financial statements. Income taxes paid were $430 million, $758 million, and $1.1 billion in 1995, 1996, and 1997.

notes continued

(In millions)

Convertible preferred stock

During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred shareholders have preference over common stockholders in dividends and liquidation rights. In December 1999, each preferred share is convertible into common shares or an equivalent amount of cash determined by a formula that provides a floor price of $79.875 and a cap of $102.24 per preferred share. Net proceeds of $980 million were used to repurchase common shares.

Common stock

Shares of common stock outstanding were as follows:

year ended june 30	1995	1996	1997
Balance, beginning of year	1,162	1,176	1,194
Issued	38	44	47
Repurchased	(24)	(26)	(37)
Balance, end of year	1,176	1,194	1,204

The Company repurchases its common stock in the open market to provide shares for issuing to employees under stock option and stock purchase plans. The Company's Board of Directors authorized continuation of this program in 1998.

Put warrants

To enhance its stock repurchase program, the Company sells put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On June 30, 1996 and 1997, 13.0 million and 3.0 million warrants were outstanding. Outstanding put warrants at June 30, 1997 expire in September 1997 and have strike prices of $105 per share. At June 30, 1996, the outstanding put warrants were settleable in cash at Microsoft's option thus resulting in a reclassification of the maximum potential repurchase obligation of $635 million from stockholders' equity to put warrants. The outstanding put warrants at June 30, 1997 permitted a net-share settlement at the Company's option and did not result in a put warrant liability on the balance sheet.

Employee stock and savings plans

Employee stock purchase plan The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1995, 1996, and 1997, employees purchased 2.1 million, 1.8 million, and 1.4 million shares at average prices of $23.38, $37.72, and $59.64 per share. At June 30, 1997, 19.4 million shares were reserved for future issuance.

Savings plan The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may defer up to 15% of pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were $12 million, $15 million, and $28 million in 1995, 1996, and 1997.

(in millions, except per share amounts)

Stock option plans The Company has stock option plans for directors, officers, and all employees, which provide for nonqualified and incentive stock options. The option exercise price is the fair market value at the date of grant. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest over seven and one-half years and expire after 10 years. At June 30, 1997, options for 113 million shares were vested and 290 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

	Shares	Price per Share Range			Weighted Average
Balance, June 30, 1994	228	$ 0.16	–	$ 25.07	$ 11.65
Granted	44	23.88	–	41.57	25.25
Exercised	(35)	0.16	–	23.88	7.91
Canceled	(9)	2.56	–	37.50	17.70
Balance, June 30, 1995	228	0.77	–	41.57	14.56
Granted	57	40.10	–	58.94	44.99
Exercised	(40)	0.77	–	45.25	10.75
Canceled	(7)	2.59	–	55.44	27.85
Balance, June 30, 1996	238	1.10	–	58.94	22.07
Granted	*55*	*55.31*	–	*119.19*	*58.29*
Exercised	*(45)*	*1.10*	–	*58.94*	*13.27*
Canceled	*(9)*	*17.00*	–	*97.13*	*38.83*
Balance, June 30, 1997	***239***	***2.24***	–	***119.19***	***31.43***

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1997 were as follows:

Range of exercise prices			Outstanding options Shares	Remaining life (years)	Weighted average price	Exercisable options Shares	Weighted average price
$ 2.24	–	$ 17.00	65	3.5	$ 9.64	64	$ 9.63
17.01	–	24.00	65	5.4	20.81	39	20.10
24.01	–	55.00	56	5.8	43.13	10	41.02
55.01	–	119.19	53	6.6	58.47	–	–

The Company follows APB Opinion 25, *Accounting for Stock Issued to Employees*, to account for stock option and employee stock purchase plans. No compensation cost is recognized because the option exercise price is equal to the market price of the underlying stock on the date of grant. Had compensation cost for these plans been determined based on the Black-Scholes value at the grant dates for awards as prescribed by SFAS Statement 123, *Accounting for Stock-Based Compensation*, pro forma net income and earnings per share would have been:

year ended june 30	1995	1996	*1997*
Pro forma net income	$1,243	$1,902	*$3,053*
Pro forma earnings per share	$ 0.99	$ 1.48	*$ 2.32*

notes continued

(in millions)

The pro forma disclosures above include the amortization of the fair value of all options vested during 1995, 1996, and 1997. If only options granted during 1996 and 1997 were valued, as prescribed by SFAS 123, pro forma net income would have been $2,073 million and $3,179 million, and earnings per share would have been $1.62 and $2.42 for 1996 and 1997.

The weighted average Black-Scholes value of options granted under the stock option plans during 1995, 1996, and 1997 was $10.46, $17.72, and $23.43. Value was estimated using an expected life of five years, no dividends, volatility of .30, and risk-free interest rates of 7.0%, 6.0%, and 6.5% in 1995, 1996, and 1997.

MSN, The Microsoft Network

During October 1996, Microsoft and a subsidiary of Tele-Communications, Inc. (TCI) terminated a partnership under which TCI owned a 20% minority interest in The Microsoft Network, LLC, owner of the business assets of MSN, an online service. Due to the evolving nature of the online industry and the move by MSN to a Web-based offering, the original direction of the partnership changed and both Microsoft and TCI agreed to terminate this partnership focused exclusively on MSN. In return for approximately $125 million of TCI securities, Microsoft became the sole owner of MSN and the minority interest on the accompanying balance sheet was eliminated. There was no other material financial impact of the dissolution.

Acquisition

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on proprietary technologies. A director of the Company owned 10% of WebTV. Microsoft paid $425 million in stock and cash for WebTV. The Company expects to record an in-process R&D write-off of $300 million in the first quarter of 1998.

Commitments and contingencies

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $86 million, $92 million, and $92 million in 1995, 1996, and 1997. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 1998, $67; 1999, $54; 2000, $43; 2001, $30; 2002, $12; and thereafter, $16.

In connection with the Company's communications infrastructure and the operation of MSN, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 1998, $133; 1999, $119; 2000, $92; and 2001, $20. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed $300 million for constructing new buildings.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture, to pay one-half of operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

In an ongoing investigation, the Antitrust Division of the U.S. Department of Justice requested information from Microsoft concerning various issues. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business. Management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

notes continued

(in millions)

Geographic information

year ended June 30	1995	1996	1997
Revenue			
U.S. operations	$ 4,495	$ 6,739	$ 8,877
European operations	1,607	2,215	2,770
Other international operations	821	1,267	1,757
Eliminations	(986)	(1,550)	(2,046)
Total revenue	$ 5,937	$ 8,671	$11,358
Operating income			
U.S. operations	$ 1,414	$ 2,137	$ 3,733
European operations	444	649	1,013
Other international operations	163	297	469
Eliminations	17	(5)	(85)
Total operating income	$ 2,038	$ 3,078	$ 5,130
Identifiable assets			
U.S. operations	$ 5,862	$ 8,193	$11,630
European operations	1,806	2,280	3,395
Other international operations	689	1,042	705
Eliminations	(1,147)	(1,422)	(1,343)
Total identifiable assets	$ 7,210	$10,093	$14,387

Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. "U.S. operations" include shipments to customers in the United States, licensing to OEMs, and exports of finished goods directly to international customers, primarily in Asia, South America, and Canada. Exports and international OEM transactions are primarily in U.S. dollars and totaled $1.3 billion, $2.1 billion, and $2.5 billion in 1995, 1996, and 1997.

"Other international operations" primarily include subsidiaries in Japan, Canada, Australia, and Brazil. International revenue, which includes European operations, other international operations, exports, and OEM distribution, was 55%, 56%, and 56% of total revenue in 1995, 1996, and 1997. Most international identifiable assets are U.S. dollar denominated investment securities.

notes continued

(in millions, except per share amounts)

Quarterly information (unaudited)

	quarter ended				
	sept. 30	dec. 31	mar. 31	june 30	year
1995					
Revenue	$ 1,247	$ 1,482	$ 1,587	$ 1,621	$ 5,937
Operating income	437	520	549	532	2,038
Net income	316	373	396	368	1,453
Earnings per share	0.25	0.30	0.32	0.29	1.16
Common stock price per share:					
High	29.63	32.56	37.06	46.19	46.19
Low	23.44	26.94	29.13	34.38	23.44
1996					
Revenue	$ 2,016	$ 2,195	$ 2,205	$ 2,255	$ 8,671
Operating income	708	786	774	810	3,078
Net income	499	575	562	559	2,195
Earnings per share	0.39	0.45	0.44	0.43	1.71
Common stock price per share:					
High	54.63	51.69	53.53	62.94	62.94
Low	42.50	40.19	39.94	49.81	39.94
1997					
Revenue	***$2,295***	***$2,680***	***$ 3,208***	***$ 3,175***	***$11,358***
Operating income	***902***	***1,081***	***1,568***	***1,579***	***5,130***
Net income	***614***	***741***	***1,042***	***1,057***	***3,454***
Earnings per share	***0.47***	***0.57***	***0.79***	***0.80***	***2.63***
Common stock price per share:					
High	***69.31***	***86.13***	***103.50***	***134.94***	***134.94***
Low	***53.75***	***65.44***	***80.75***	***89.75***	***53.75***

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1997, there were 53,390 holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

subsidiaries

Microsoft Corporation
One Microsoft Way
Redmond, WA
98052-6399

Microsoft FSC Corp.
(U.S. VIRGIN ISLANDS)

Microsoft Investments, Inc.
(NEVADA)

Microsoft Licensing, Inc.
(NEVADA)

Microsoft Manufacturing B.V.
(THE NETHERLANDS)

Microsoft Puerto Rico, Inc.
(Manufacturing)
(DELAWARE)

Microsoft Research Limited
(UNITED KINGDOM)

The Microsoft Network L.L.C.
(DELAWARE)

GraceMac Corporation
(NEVADA)

Vermeer Technologies, Inc.
(DELAWARE)

Microsoft de Argentina S.A.

Microsoft Pty. Limited
(AUSTRALIA)

Microsoft Gesellschaft m.b.H.
(AUSTRIA)

Microsoft N.V.
(BELGIUM)

Microsoft Informatica Limitada
(BRAZIL)

Microsoft Canada Co.

SOFTIMAGE, Inc.
(CANADA)

Microsoft Chile S.A.

Microsoft Colombia Inc.
(DELAWARE)

Microsoft de Centroamérica S.A.
(COSTA RICA)

Microsoft Hrvatska d.o.o.
(CROATIA)

Microsoft s.r.o.
(CZECH REPUBLIC)

Microsoft Danmark ApS
(DENMARK)

Microsoft Del Ecuador S.A.

Microsoft Corporation
(Representative Office)
(EGYPT)

Microsoft Oy
(FINLAND)

Microsoft France S.A.R.L.

Microsoft G.m.b.H.
(GERMANY)

SOFTIMAGE G.m.b.H.
(GERMANY)

Microsoft Hellas S.A.
(GREECE)

Microsoft de Guatemala, S.A.

Microsoft Hong Kong Limited

Microsoft Hungary Kft.

Microsoft Corporation (India) Private Limited

PT. Microsoft Indonesia

Microsoft Israel Ltd.

Microsoft S.p.A.
(ITALY)

Microsoft Côte d'Ivoire
(IVORY COAST)

Microsoft Company, Limited
(JAPAN)

East Africa Software Limited
(KENYA)

Microsoft CH
(KOREA)

Microsoft (Malaysia) Sdn. Bhd.

Microsoft México, S.A. de C.V.

Microsoft Maroc S.A.R.L.
(MOROCCO)

Microsoft B.V.
(THE NETHERLANDS)

Microsoft International B.V.
(THE NETHERLANDS)

Microsoft New Zealand Limited

Microsoft Norge AS
(NORWAY)

Microsoft de Panama, S.A.

Microsoft (China) Company Limited
(THE PEOPLE'S REPUBLIC OF CHINA)

Microsoft Peru, S.A.

Microsoft Philippines, Inc.

Microsoft sp. z.o.o.
(POLAND)

MSFT-Software Para Microcomputadores, LDA
(PORTUGAL)

Microsoft Caribbean, Inc.
(PUERTO RICO)
(DELAWARE)

Microsoft Romania SRL

Microsoft ZAO
(RUSSIA)

Microsoft Singapore Pte Ltd

Microsoft Slovakia s.r.o.

Microsoft d.o.o., Ljubljana
(SLOVENIA)

Microsoft (S.A.) (Proprietary) Limited
(SOUTH AFRICA)

Microsoft Iberica S.R.L.
(SPAIN)

Microsoft Aktiebolag
(SWEDEN)

Microsoft AG
(SWITZERLAND)

Microsoft Taiwan Corporation

Microsoft (Thailand) Limited

Microsoft Bilgisayar Yazilim Hizmetleri Limited Sirketi
(TURKEY)

Microsoft Corporation
(UNITED ARAB EMIRATES)

Microsoft Limited
(UNITED KINGDOM)

SOFTIMAGE U.K. Limited

Microsoft Uruguay S.A.

Corporation MS 90 de Venezuela S.A.

The Resident Representative Office of MICROSOFT Corporation in Hanoi
(VIETNAM)

DreamWorks Interactive L.L.C.
(WASHINGTON, 50% owned)

MSBET L.L.C.
(DELAWARE, 50% owned)

MSFDC, L.L.C.
(DELAWARE, 50% owned)

MSNBC Cable, L.L.C.
(DELAWARE, 50% owned)

MSNBC Interactive News, L.L.C.
(DELAWARE, 50% owned)

reports of management and independent auditors

Management is responsible for preparing the Company's financial statements and related information that appears in this annual report. Management believes that the financial statements fairly reflect the form and substance of transactions and reasonably present the Company's financial condition and results of operations in conformity with accounting principles generally accepted in the United States and International Accounting Standards. Management has included in the Company's financial statements amounts that are based on estimates and judgments, which it believes are reasonable under the circumstances.

The Company maintains a system of internal accounting policies, procedures, and controls intended to provide reasonable assurance, at appropriate cost, that transactions are executed in accordance with Company authorization and are properly recorded and reported in the financial statements, and that assets are adequately safeguarded.

Deloitte & Touche LLP audits the Company's financial statements in accordance with generally accepted auditing standards and provides an objective, independent review of the Company's internal controls and the fairness of its reported financial condition and results of operations.

The Microsoft Board of Directors has an Audit Committee composed of nonmanagement Directors. The Committee meets with financial management, internal auditors, and the independent auditors to review internal accounting controls and accounting, auditing, and financial reporting matters.

Gregory B. Maffei
Vice President, Finance;
Chief Financial Officer

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1996 and 1997, and the related statements of income, cash flows, and stockholders' equity for each of the three years ended June 30, 1997, appearing on pages 24, 25, 32, 33, and 34 through 43. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1996 and 1997, and the results of their operations and their cash flows for each of the three years ended June 30, 1997 in conformity with accounting principles generally accepted in the United States and International Accounting Standards.

Deloitte & Touche LLP

Deloitte & Touche LLP
Seattle, Washington
July 17, 1997
(August 1, 1997 as to Acquisition Note)

directors and officers

Directors

William H. Gates
Chairman of the Board;
Chief Executive Officer,
Microsoft Corporation

Paul G. Allen
Founder, Asymetrix Corp.;
Owner, Starwave Corp.;
Interval Research Corp.;
Vulcan Ventures Inc.

Jill E. Barad
President and
Chief Executive Officer,
Mattel, Inc.

Richard A. Hackborn
Executive
Vice President,
Hewlett-Packard
Company (retired)

David F. Marquardt
General Partner,
Technology Venture
Investors and
August Capital

Robert D. O'Brien
Through November 14, 1997
Chairman of the Board,
PACCAR, Inc. (retired)

Wm. G. Reed, Jr.
Chairman, Simpson
Investment Company

Jon A. Shirley
President and
Chief Operating Officer,
Microsoft Corporation
(retired)

Officers

William H. Gates
Chairman of the Board;
Chief Executive Officer

Steven A. Ballmer
Executive Vice President,
Sales and Support

Robert J. Herbold
Executive Vice President;
Chief Operating Officer

Frank M. (Pete) Higgins
Group Vice President,
Interactive Media

Paul A. Maritz
Group Vice President,
Platforms and
Applications

Nathan P. Myhrvold
Group Vice President,
Chief Technology Officer

Jeffrey S. Raikes
Group Vice President,
Sales and Marketing

James E. Allchin
Senior Vice President,
Personal and Business
Systems Group

Joachim Kempin
Senior Vice President,
OEM Sales

Michel Lacombe
Senior Vice President,
Microsoft;
President,
Microsoft Europe

Craig Mundie
Senior Vice President,
Consumer Platforms

William H. Neukom
Senior Vice President,
Law and Corporate
Affairs; Secretary

Brad A. Silverberg
Senior Vice President,
Applications and
Internet Client Group

Bernard P. Vergnes
Senior Vice President,
Microsoft;
Chairman,
Microsoft Europe

Orlando Ayala Lozano
Vice President,
Intercontinental Region

Robert J. Bach
Vice President,
Learning and
Entertainment

Michael W. Brown
Vice President,
Finance;
(Chief Financial Officer,
retired)

Brad Chase
Vice President,
Developer Relations
and Marketing, Internet
Client and Collaboration

Frank M. Clegg
Vice President,
Central United States
and Canada Region

David Cole
Vice President,
Internet Client and
Collaboration

John G. Connors
Vice President,
Information Technology;
Chief Information Officer

Jon DeVaan
Vice President,
Desktop Applications

Richard R. Devenuti
Vice President,
Operations

Moshe T. Dunie
Vice President,
Windows Operating
Systems

Richard Fade
Vice President,
Desktop Applications

Dianne L. Gregg
Vice President,
Eastern United States
Region

Paul Gross
Vice President,
Developer Tools

Sam Jadallah
Vice President,
Organization
Customer Unit

Laura Jennings
Vice President,
The Microsoft Network

John Lauer
Vice President,
Far East Region

John Leftwich
Vice President,
Europe Marketing

Lewis Levin
Vice President,
Desktop Finance

John Ludwig
Vice President,
Internet Client
and Collaboration

Gregory B. Maffei
Vice President,
Finance;
Chief Financial Officer

Robert L. McDowell
Vice President,
Enterprise Business
Relationships

Bob Muglia
Vice President,
Server Applications

Mike Murray
Vice President,
Human Resources
and Administration

Cameron Myhrvold
Vice President,
Internet Customer Unit

John F. Neilson
Vice President,
Interactive Service Media

Peter Neupert
Vice President,
News, Sports,
and Commentary

Chris Peters
Vice President,
Web Authoring

Rick Rashid
Vice President,
Research

Jon Reingold
Vice President,
Office Marketing

Darryl E. Rubin
Vice President,
Advanced Architecture

Stephen A. Schiro
Vice President,
End-User Customer Unit

Charles Stevens
Vice President,
Application Developers
Customer Unit

Rick Thompson
Vice President,
Hardware

Richard Tong
Vice President,
Marketing, Desktop
and Business Systems

David Vaskevitch
Vice President,
Database and
Transactions

Joe Vetter
Vice President,
Western United States
Region

Deborah N. Willingham
Vice President,
Enterprise
Customer Unit

shareholder services

http://www.microsoft.com/msft/

As a Microsoft shareholder, you're invited to contact us for a variety of shareholder services or to request more information about Microsoft. Here are some suggestions on how to reach us:

Account questions

Our transfer agent can help you with a variety of shareholder-related services, including:

- Change of address
- Lost stock certificates
- Transfer of stock to another person
- Additional administrative services

You can call our transfer agent toll-free at (800) 285-7772.

You can also write them at:

ChaseMellon
Shareholder Services
P.O. Box 3315
South Hackensack, NJ
07606-1915

Or you can e-mail our transfer agent at: msft@chasemellon.com

Shareholders of record who receive more than one copy of this annual report can contact our transfer agent and arrange to have their accounts consolidated. Shareholders who own Microsoft stock through a brokerage can contact their broker to request consolidation of their accounts.

Investor relations

You can contact Microsoft's Investor Relations group any time to order financial documents such as this annual report and the Form 10-K. Call us toll-free at (800) 285-7772. (Outside the United States, call (425) 936-4400.) Or send a fax to (425) 936-8000. We can be contacted during West Coast business hours to answer investment-oriented questions about Microsoft. In addition, you can write us at:

Investor Relations Department
Microsoft Corporation
One Microsoft Way
Redmond, Washington
98052-6399

Or better yet, send us an e-mail at msft@microsoft.com

Annual meeting

Microsoft shareholders are invited to attend our annual meeting, which will be held on Friday, November 14, 1997 from 8 to 9 A.M. at the Washington State Convention and Trade Center, 800 Convention Place, Seattle, Washington.

Get financial information online

Anyone with access to the Internet can view an electronic copy of this annual report along with a wide variety of other financial materials at http://www.microsoft.com/msft/

About the cover

We are dedicated to making the Microsoft brand one of the most recognized in the world. Our brand is defined in part by the use of four colors that represent the diverse and dynamic nature of the company. Our 1997 Annual Report covers use these colors in four different configurations in recognition of that strategy.

Recycled paper

Microsoft

Where do you want to go today?

0997 Part No. 098-70712